ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Alarcon	Analyst:	John Pavalasky	Bill Number:	SB 819
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	February 21, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Business Expense Deduction/Disallow Excessive Employee Remuneration

SUMMARY

This bill would not allow corporations to deduct salaries of over $1 million dollars paid to any executive officer of the corporation unless it pays each of its employees at least double the state minimum wage.

PURPOSE OF THE BILL

The bill states that California should reward those corporations that have maintained reasonable executive salaries, including bonuses, perks, and stock options, and those corporations that adjust executive salaries to more reasonable levels. It also states that it is the intent of the Legislature to foster an environment of corporate responsibility and transparency in this state.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Under both state and federal law a corporation carrying on a trade or business is allowed to deduct a reasonable allowance for salaries or other compensation for personal services. However, publicly held corporations are generally not able to deduct compensation paid to certain covered employees to the extent that the compensation exceeds $1 million per tax year. The $1 million limit does not apply to performance-based compensation.

Board Position:			Department Director	Date
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THIS BILL

This bill would expand the number of corporations subject to the salary cap to include any corporation domiciled or engaged in business in this state and, thus, would include closely-held corporations.

The bill would expand the number of executives of the corporation subject to the salary cap from the chief executive officer and the four highest paid employees for the taxable year to include any executive officer of the corporation.

Also, the cap itself would be lowered in certain cases because the maximum would be changed from over $1 million to the lesser of $1 million or the amount that is equal to 100 times the salary of the corporation's least paid employee. If the least paid employee is paid less than $10,000 during the taxable year, the cap would be less than $1 million.

In addition, this bill would eliminate the exception to the salary cap for salaries paid for the attainment of performance goals as determined by a compensation committee of the company's board of directors.

However, this bill would also provide that the corporation would be exempt from any salary cap if it pays each of its employees, including contract employees, at least double the state minimum wage.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

The bill does not contain a definition of "any corporation domiciled or engaged in business in this state," "least paid employee," "an executive officer of the taxpayer or an individual acting in that capacity," or "contract employees." In order to avoid confusion due to the differences between federal and state law that this bill introduces, the author should consider including a definition of these terms to the bill.

LEGISLATIVE HISTORY

AB 1122 (Stats. 2002, Ch. 35) conformed state law to the federal denial of deductions for excess employee salaries by corporations for taxable years beginning on or after January 1, 2002.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. All these states begin the state return with federal taxable income. Thus, they conform to the federal rules denying excess employee salaries paid by corporations in excess of $1 million.

FISCAL IMPACT

If this bill were amended to resolve the implementation considerations, implementing this bill would be accomplished during the normal annual update.

ECONOMIC IMPACT

Revenue Estimate

No specific revenue estimate can be developed at this time due to definitional questions raised in the analysis.

Estimates for revenue gains were projected previously for conforming state law to the federal denial of deductions for excess employee salaries (Stats. 2002, Ch. 35). These estimates were $4 million, $4 million, and $5 million for fiscal years 2002-03, 2003-04, and 2005-06, respectively.

While the bill would potentially increase the number of high-paid individuals subject to a deduction limitation, the minimum wage exception, which removes the deduction limitation, would most likely have a greater (negative) impact on revenues.

ARGUMENTS/POLICY CONCERNS

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

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